Statement of

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Commodity Futures Trading Commission

Fiscal Year 2001 Budget Request

Before the

House Appropriations Committee

Subcommittee on Agriculture, Rural Development, FDA, and Related Agencies

INTRODUCTION

I am pleased to provide this written testimony to the Chairman and Members of the Subcommittee in support of the President's fiscal year 2001 budget request for the Commodity Futures Trading Commission ("CFTC" or "Commission"). This statement provides an overview of the proposed budget for 2001; discusses the need for additional program resources; and expresses my perspective on reauthorization and the Commission's recent regulatory reform efforts.

The CFTC is responsible for fostering the economic utility of futures markets by encouraging their competitiveness and efficiency, ensuring their integrity, and protecting market participants against manipulation, abusive trade practices, and fraud. The Commission is developing a new framework that substantially alters its traditional approach to regulating the futures industry. The framework is intended to provide a flexible response to the changes that are taking place in the futures markets, particularly technological innovations that offer faster and more efficient ways to buy and sell futures and option contracts.

REQUEST FOR APPROPRIATIONS IN FISCAL 2001

The President's FY 2001 budget request for the Commission is \$72.0 million, with 621 full-time equivalent employees (FTEs). This represents an increase of \$9.2 million and 60 FTEs over the FY 2000 appropriation. Approximately \$5.3 million of this increase is necessary for the Commission to maintain its current level of services and operations. The remaining \$3.9 million increase would support the addition of the 60 FTE staff-years, an 11 percent increase in staffing. The budget request would provide the Commission with the resources needed to perform its legislative mandate under the Commodity Exchange Act ("CEA" or "Act"). The requested increases reflect the futures industry's growth and the changes taking place within it.

OVERVIEW OF FUNDING LEVELS AND OPERATIONAL EFFECTS

The CFTC supervises all trading of futures and option contracts on U.S. futures exchanges and is responsible for ensuring the economic utility of these markets. This entails ensuring market integrity by monitoring the markets to detect and prevent price distortions and manipulation, assuring the financial integrity of intermediaries handling customer funds, protecting customers from fraud and other trading abuses, and encouraging the competitiveness and efficiency of the nation's futures exchanges. Through effective oversight regulation, the CFTC enables the futures markets to serve more effectively their vital function in the nation's economy--providing a mechanism for price discovery and a means of offsetting price risks.

Increased exchange-trading volume: The futures and option markets have experienced dramatic growth, doubling in the last decade (from 334 million to 614 million contracts). The CFTC must monitor the increases in volume and the complexity of trading activity in order to ensure that U.S. market users are able to trust the safety, fairness, and transparency of trading on the U.S. exchanges.

Innovation: The number of actively traded contracts on the U.S. exchanges is estimated to reach a high this year of just under 300 contracts, nearly triple the number available for market users just a decade ago. Four hundred and seventy-nine new futures and option contracts were approved in the last decade.

The Commission last year reviewed and approved 73 applications for new futures and option contracts, 30 of which were submitted under fast-track procedures. New contracts approved include weather-related futures and options contracts submitted by the Chicago Mercantile Exchange based on heating degree days and cooling degree days for 10 cities. These were the first contracts to be approved that are derived from weather-related data.

The Commission recently granted the exchanges the authority to self-certify new contracts instead of submitting them to the CFTC for review and approval but lacks sufficient experience to tell whether this optional authority will supplant traditional contract review processes. Since the self-certification authority went into effect, six contracts have been self-certified, six have been submitted under existing designation procedures, and two have been submitted under both

Growing managed funds: The CFTC regulates commodity pool operators ("CPOs") and commodity trading advisors ("CTAs"). Funds committed to professional management for futures trading have grown dramatically, from \$115 million in 1975 to nearly \$44 billion today. This statistic does not include hedge funds exempt from CFTC registration requirements under Rule 4.5 or otherwise not within the Commission's jurisdiction. Funds under professional management include a growing number of pension and mutual funds; they warrant continued oversight by the Commission to ensure the protection of these customer funds.

Market globalization: World futures and option markets are inextricably linked. In this rapidly developing global market, U.S. futures markets must retain their world leadership. To accomplish this objective, the CFTC's regulatory structure must not present obstacles to market innovation and growth. Through electronic trading systems and Internet trading, markets respond to information and the needs of their users 24 hours a day. The trading strategies employed globally are increasingly complex and the issues associated with cross-border business are more prevalent. Failure by the CFTC to keep its supervision systems technologically current and to retain and attract qualified staff are a necessary component to help keep U.S. markets and market users leaders in the world marketplace.

¹ Including two stock index contracts not eligible for certification.

Technology in the marketplace: Exchanges are turning increasingly to electronic trading systems, including Internet-based trading systems. The potential benefits of technology include faster and more efficient executions; potentially significantly lower transaction costs; and cross-market clearing, netting and offsetting systems. In the course of its review of initiatives undertaken by exchanges, clearinghouses and other major participants in the futures and options industry, the Commission engages in a broad range of activities, including: reviewing applications for approval of proposed electronic futures and options trading systems and assisting with the development of standards of screen-based trading systems for futures and options. New technology in the futures industry is developing at a phenomenal pace with increasing complexity. The Commission requires staff knowledgeable to address these developments.

Cooperation with other federal and international regulators:

The Chairman of the CFTC is one of the four principal members of the President's Working Group on Financial Markets (PWG) along with the Secretary of the Treasury, the Chairman of the Board of Governors of the Federal Reserve System and the Chairman of the Securities and Exchange Commission. The PWG is a forum for the coordination of federal financial regulation across markets. In April of 1999, the PWG issued a report entitled "Hedge Funds, Leverage and the Lessons of Long Term Capital Management." This report reviewed the events surrounding the near-collapse of the Long Term Capital Management fund. Among other recommendations, the report proposed that CPOs of certain large commodity pools file quarterly reports. Commission staff, in cooperation with the Steering Committee of the PWG, is working with other agencies and Congress to implement the recommendations of that report as they apply to reporting requirements of Commission registrants. The PWG also issued a report in November 1999 entitled "Over-the-Counter Derivatives Markets and the Commodity Exchange

Act.² The report focused on changes to the CEA designed to promote innovation, competition, efficiency and transparency in OTC derivatives markets, to reduce systemic risk, and to allow the United States to maintain leadership in the rapidly developing markets.

The CFTC also is an active participant in the International Organization of Securities

Commissions (IOSCO). As a member of IOSCO, the CFTC works closely with other
international regulators to establish benchmark standards for disclosure, auditing and accounting,
contract design, financial integrity and core principals for market regulation and enforcement,
among others. CFTC staff currently are involved in an IOSCO working party project to develop
a consensus on general international principles to facilitate the review or approval by regulators
in one country of electronic systems operated by a sponsor in another country. CFTC staff
recently completed their substantial contribution to a comprehensive IOSCO report on
manipulation to be published in May 2000, focusing on cross border and cross market
misconduct in derivatives and securities markets. The manipulation mandate arose out of an
initiative by the CFTC, known as the Tokyo Communique, that addressed the threat of
manipulation in delivery markets. CFTC staff are currently organizing several enforcement
initiatives with IOSCO members, including hosting the second international Internet surveillance
experts training session in June 2000 as well as developing a practical guide for the effective
conduct of joint and parallel investigations and prosecutions with foreign regulators.

CFTC RESOURCES

The proposed increase in funding is necessary to enable the Commission to keep pace with the continued growth in volume and the profound changes in the industry resulting from novel transactions, new trading systems, new market participants, advances in technology, and

² Copies of both PWG reports and CFTC Chairman William Rainer's February 10th testimony before the Senate Agriculture Committee on OTC derivatives are available upon request.

the globalization of the markets. These additional resources would be dedicated primarily to maintaining effective enforcement and surveillance oversight. In addition, the Commission must remain responsive to technological developments, business changes, and market evolution so that innovation and financial market growth are not burdened with regulatory inefficiencies and outmoded regulatory structures.

Over one-third of the funding increase will go to the Commission's Enforcement program, which would receive an allocation of 24 additional staff-years. This allocation would bring the program to its strongest level of support in the Commission's history with a full complement of 182 full-time staff-years. The 24 additional staff would be devoted to the investigation and prosecution of fraud, including quick strike efforts, when customer funds are at risk, and cases involving larger, more complex market issues. The Commission is responding to growing concerns in the area of Internet and electronic trading. We have seen an increase in the number of unregistered trading advisors fraudulently selling trading systems to retail customers and unregistered pool operators defrauding public investors by taking advantage of the trend toward managed funds. Additionally, the need for cooperative enforcement efforts remains strong, both domestically and internationally to deal with complex schemes that affect markets and traders across brokers. These efforts enhance the Commission's ability to detect and investigate potential wrongdoing.

Futures industry growth and changes which include the proliferation of exchanges and products, the need to oversee the development of complex market linkages and trading mechanisms the growth of money under management, and the changing role of intermediaries increase demands on program resources. Accordingly, the second largest increase in full-time staff would be 17 additional staff-years dedicated to the Trading and Markets program.

Furthermore, in its move from frontline regulation to oversight, the CFTC must enhance its oversight functions to ensure that self-regulatory responsibilities are met by the exchanges.

The President's budget would anticipates adding nine additional staff-years to the Market Surveillance, Analysis and Research program. Most of the new staff would be used to strengthen the Commission's expertise in the increasingly innovative and diverse markets being developed by both traditional and electronic exchanges.

These growing programs require increased expert legal counsel. Thus, the budget request contains five additional staff-years for the Office of General Counsel. The contemplated increase in enforcement activity will result in a related increase in administrative and judicial appellate litigation. Moreover, changes within the industry and within the Commission's regulatory structure will generate an increased demand for the legal analysis and legal counsel services provided by the Office.

Finally, five full-time staff are needed in the Executive Direction and Support programs to continue to support effectively the Commission's major programs. These additional staff will assist the Commission in keeping pace with technology – for example, in the area of automated research and records in the Office of the Secretariat – and to support the Commission's mission-critical software systems development. They are also needed to ensure the appropriate level of professional support for the Commission's leases, contracts, and major procurements.

The requested increase in funding and staffing will strengthen the Commission and increase its ability to oversee the vital and changing futures and option markets that are an integral and growing part of the United States economy and world marketplace.

PAY DISPARITY ISSUES

The ability of the Commission to carry out its mandate is dependent on the hiring and retention of competent employees. I have been impressed by the quality and dedication of the men and women who work at the CFTC. I am concerned, however, about the high turnover among our professional staff, especially among attorneys. Even more disturbing is that many of the attorneys who leave the CFTC move to positions at other financial regulators, most of which pay higher salaries than the CFTC. Chairman Levitt of the Securities and Exchange Commission recently has begun a campaign to raise the level of salaries of the SEC staff. CFTC salaries must also increase. Of the seven major financial regulators, all but the CFTC have some form of premium pay. Congress needs to address this disparity and I will be discussing it with the Agriculture Committees as they proceed with reauthorization of the CFTC. The proposal I intend to make, which is nearly identical to Chairman Levitt's proposal, will remove the CFTC from the salary restrictions set forth in Title V of the U.S. Code and allow it to set salaries comparable to those of the other financial regulators. I believe the Commission plays a vital role in the Federal financial community and its staff must be compensated at levels comparable to other Federal financial regulators. I would be willing to forgo some of the staff increases in the President's budget in order to be able to use those funds to pay higher salaries to attract and retain the highest quality staff for the CFTC.

REAUTHORIZATION

Since Congress created the CFTC through the enactment of the Commodity Futures

Trading Commission Act of 1974 as an amendment to the Commodity Exchange Act, the CFTC has been subject to periodic review and reauthorization by the Congress. In 1995, Congress authorized the CFTC for a period ending September 30, 2000. Traditionally, Congress utilizes the reauthorization process to perform oversight of the Commission, to re-examine the laws

governing futures transactions, to enact substantive changes in the law where necessary, and to extend the Commission's authorization to receive appropriations.

On July 1, 1999 Senator Richard Lugar, Chairman of the Senate Committee on Agriculture, Nutrition, and Forestry, and Representative Thomas Ewing, Chairman of the House Subcommittee on Risk Management, Research and Specialty Crops, issued a joint press release which set forth the following parameters for CFTC reauthorization.

Legislation should:

- 1. Revamp functions of the CFTC to transform the agency from a "frontline" regulator to an "oversight" agency as long as such changes do not conflict with the public interest;
- 2. Clarify and refocus the jurisdiction of the CFTC without significantly expanding its original grant of authority;
 - 3. Streamline and eliminate unnecessary regulations for the futures exchanges;
- 4. Incorporate how the emergence of electronic trading may require a different level and approach to regulation; and
- 5. Provide legal certainty for OTC derivatives and reform the Shad-Johnson Accord as regulatory disparities are addressed.

The Commission will be working closely with the Congress to help ensure that reauthorization of the Commission prior to September 30, 2000 can be achieved. Specific legislation reauthorizing the CFTC is being drafted by Congress at this time. Many of the issues raised by Chairmen Lugar and Ewing in their July 1, 1999 release have been the subject of Congressional hearings, roundtables, and educational seminars for Congressional staff. Commission rulemakings, roundtables, and advisory committee meetings have also addressed these issues. Introduction of legislation and additional hearings are anticipated in the near future.

SHAD-JOHNSON REFORM

The Shad-Johnson jurisdictional accord ("Accord") was an agreement reached between the Chairmen of the SEC and CFTC during the 1982 reauthorization to clarify the jurisdiction of each agency over certain security-based derivatives. Under the Accord the CFTC was authorized to permit trading in stock-index futures on the nation's futures exchanges, provided the futures contracts were cash-settled, not readily susceptible to manipulation, and based on a broad or substantial segment of the equity or debt market. All such contracts proposed to be traded on futures exchanges were subject to initial SEC review before they could be reviewed and approved by the CFTC. Futures on individual non-exempt securities, such as corporate stock or debt, were prohibited. Congress subsequently codified the Accord as a part of the 1982 CFTC reauthorization.

Trading in stock index futures has proved to be successful and some industry representatives have expressed the opinion that the restrictions in the Accord, particularly the prohibition on single stock futures, should be repealed.

This matter was of sufficient importance to Congress that Chairman Lugar of the Senate Agriculture Committee and Chairman Gramm of the Senate Banking Committee wrote a joint letter to the SEC and the CFTC on December 17, 1999, and Chairman Combest of the House Committee on Agriculture, Chairman Bliley of the House Committee on Commerce, Congressman Stenholm, Ranking Member, Committee on Agriculture, and Chairman Ewing of the House Agriculture Subcommittee on Risk Management, Research and Specialty Crops wrote a joint letter to the SEC and CFTC on January 20, 2000, requesting a report addressing the desirability of lifting the current prohibition on single stock futures together with any legislative proposals. The two agencies worked diligently to formulate an appropriate response and

responded with a joint letter on March 2, 2000. While the two agencies made substantial progress on addressing single stock futures, some of the outstanding issues were not resolved. However, it was agreed that the agencies would continue to work together to reach further consensus on the regulatory issues and to provide a comprehensive legislative proposal to Congress.

REFORMING THE REGULATION OF EXCHANGE TRADED FUTURES

As an initial step in the regulatory reform process, the CFTC has adopted regulations withdrawing the requirement that the Commission approve applications by futures exchanges to be designated as contract markets before listing new products for trading. As a second step the Commission has issued proposed regulations to permit exchanges to adopt certain rule changes without prior approval. These are key elements in our overall plan to move from being a frontline to an oversight regulator.

Late last year, I formed a staff task force to create a new regulatory framework. To assist in this effort, the Commission held two public roundtables and one Agriculture Advisory Committee meeting. Moreover, to assure that the task force considered an array of perspectives, the staff met frequently with participants in the derivatives markets, who represented a range of industry views. The resulting staff recommendation for a new regulatory framework has been shared with industry, other government agencies and our oversight committees in Congress.

The new framework is a work in progress on which there has been no Commission action. Although I believe the framework goes a long way toward resolving difficult regulatory issues posed by changing market conditions, there nonetheless will be plenty of opportunity for comment, debate, and where necessary, alteration. The CFTC will hold at least one public hearing on this framework.

The public interest demands that we acknowledge the differences among futures contracts and adjust our regulatory burden to a level commensurate with the nature of the product traded and the type of entity trading it. Accordingly, flexibility is the hallmark of the new framework. The plan replaces the concept of a designated contract market with two new kinds of trading facilities: recognized futures exchanges (RFEs) and derivatives transaction facilities (DTFs), each of which would be subject to a different level of Commission oversight. The framework also contemplates a category of exempt multilateral trade execution facilities—exempt MTEFs—which would operate on an unregulated basis. While the framework invites change, it does not impose it on established futures exchanges. Existing exchanges operating as contract markets *may* reorganize under the terms of the framework; however they are not compelled to do so.

The multi-tiered design takes into account important differences among underlying commodities and the different levels of financial sophistication among traders. Of the new trading facilities described in the framework, recognized futures exchanges—RFEs—will be subject to the greatest degree of CFTC oversight. Recognized futures exchanges may list any commodity and offer open access to all trading participants. Unlike designated contract markets, which operate under a number of detailed, prescriptive rules, recognized futures exchanges will be subject to 15 core principles that can be adapted to the needs and practices of individual market participants.

Upon adoption of the framework, the RFE model could be used immediately by existing exchanges. Moreover, this regulatory structure inherently removes barriers to entry faced by start-up, electronic trading platforms that may want to attract a broad-based market. Such a platform could seek recognition as an RFE and avoid the process of filing an application under

rules designed for a traditional board of trade. The 15 core principles applicable to RFEs nevertheless capture all essential elements of an effective regulatory structure and meet generally applicable international standards, including requirements for transparency, fair trading standards, financial integrity and customer protection.

The second new trading facility proposed in the framework, the recognized DTF, may be of great benefit to both existing exchanges and to startups. The DTF category establishes a facility subject to seven core principles. It represents a recognition that not all commodities are alike, and that, as a consequence, the nature of the product that underlies a derivative transaction affects the level of regulation that ought to govern that market. Fewer core principles apply because generally a DTF may offer (i) contracts only on underlying commodities that have a nearly inexhaustible deliverable supply or no underlying cash market, or (ii) contracts that have been determined on a case-by-case basis to be appropriate for listing on a DTF, or (iii) contracts traded only by commercial traders, regardless of the nature of the underlying commodity.

The framework describes a third class of trading facility, exempt MTEFs, which will not bear the imprimatur of Commission recognition. These will be limited to institutional traders and to markets with no underlying cash market or virtually inexhaustible deliverable supplies.

Consequently, they will be exempt from all provisions of the Act except prohibitions against fraud and manipulation.

This reform of the regulatory architecture is still being developed and represents a departure from the current one-size fits all approach. These markets serve a vital public interest best served when they function efficiently. We at the CFTC are committed to finding viable solutions to enable these markets to prosper and the U.S. to maintain its customary leadership role in world finance.

At this time, the new regulatory framework is a staff proposal and the Commission has not yet taken official action on it. Consequently, it would be premature to assess definitively any budget impact. Nevertheless, if the proposals are adopted and the Commission changes the emphasis of its regulatory efforts, then it would be logical to conclude that our resources would be reallocated to better reflect the Commission's new direction in carrying out its statutory mission.

A goal of this regulatory reform effort is to enhance competition in these markets. Some of the anticipated benefits of this new competition may be an increase in the number of new products and exchanges, making it necessary for the Commission to have adequate resources to meet the regulatory requirements of an expanded marketplace.

CONCLUSION

I am pleased to provide this statement in support of the President's request for \$72 million for the Commodity Futures Trading Commission for FY 2001 and would be happy to provide the Subcommittee any additional information it may require.